CHASE

International Finance

Vol. XVIII, No. 5
February 28, 1983

Issued biweekly by the Economics Group of The Chase Manhattan Bank for corporate customers and correspondent banks. Managing Editor: Diana J. Rich

B1900-1 3/1/83

An Expansionary Budget For the British?

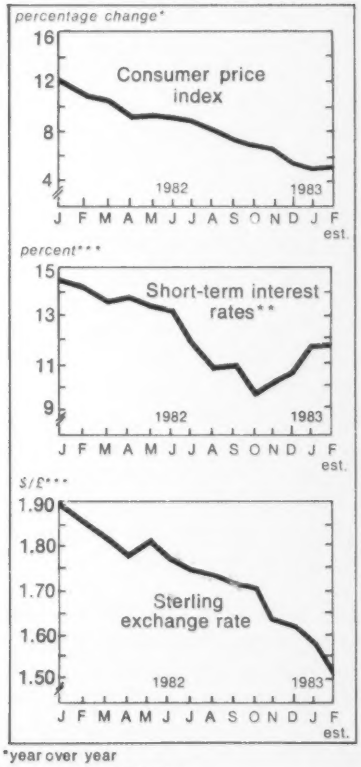
If history is any guide to the future, Great Britain will see a giveaway budget on March 15. Unemployment now stands at 12.8% of the workforce while industrial output has fallen almost 12% from 1979's peak to a level not seen since 1975. Most of the constraints that have argued against expansion in the last several budgets have been lifted: At an annual rate, the current account was in surplus to the tune of $8 billion in the fourth quarter of last year. Furthermore, the year-on-year inflation rate tumbled from 12% in January 1982 to 5.4% at year-end, and with the first two months of 1983 posting rates near 5%, further falls are expected. Even the budget deficit is now under control and at about £8 billion, or 3.2% of GNP, is smaller than the government had aimed for. Political forces also point to an expansionary budget; with a general election widely expected before 1983 is out, the March budget will be the government's last opportunity to present a popular program to the electorate.

Nevertheless, while the elements needed to justify a shift to a more reflationary policy stance clearly have been falling into place, the government's freedom of action has been severely limited by the weakness of the pound sterling. Despite interest-rate hikes last November and again in January, the pound has continued to fall against almost all currencies and, with the oil market in a state of uncertainty, sterling still looks exposed.

Odds are, nonetheless, that the March budget will be strongly expansionary. The Thatcher government will probably argue that much of the recent fall in the pound represents an adjustment to past overvaluation, and—provided that it is reelected—there is little reason for a further selloff. Judged in terms of relative inflation rates, sterling is only about 6% overvalued today. And unless the world price of oil falls so low that Britain's differential advantages as an oil exporter disappear, some degree of overvaluation is to be expected in the future. With the prospect of continuing low inflation and a large—although falling—balance-of-payments surplus, substantial further declines of the pound seem unlikely.

Thus, the government can be expected to inject some £2 billion into the economy, mostly by means of cuts in personal taxation. Without the recent weakness of the pound, cuts in interest rates could also have been expected, but it is now likely that interest rates will be used mainly to influence the exchange rate. As a result, their movement will depend upon the fortunes of sterling.

British inflation, interest rates, and the value of the pound



*year over year
**3-month interbank rates
***end of period

© 1983—Economics Group, The Chase Manhattan Bank, N.A.

Strong budget medicine for Ireland's ailing economy.

Tough policies will have to be kept in place for some time before Ireland's economy can be described as healthy, but there are signs that things are beginning to improve. The new government unveiled a tough budget earlier this month that reflected big tax increases and a reduction in the budget deficit. The deficit is now expected to be roughly £800 million or 7% of GDP in 1983 compared with £988 million in 1982, some 8% of GDP. Higher taxes are expected to lead to a 1% decline in consumer spending this year; GDP growth will probably slow to about 0.5% from 1982's 1.8%. The tax hikes will also add to inflation pressures, although the pre-tax rate of inflation is on a sharp enough downtrend that prices overall are expected to decelerate to about a 14% rate of increase from last year's 17.1%. Despite the stringent budget measures, Ireland's public-sector debt now equals about 45% of GDP, with debt servicing costs totaling some 20% of merchandise export revenue. It is anticipated that the current-account deficit will be reduced to £800 million in 1983 from £1 billion last year. But even this is still large, suggesting a continued need to borrow abroad for the next few years.

Denmark expected to maintain policy restraint.

The Danish economy is beginning to show the effects of the conservative government's austerity program announced last fall. Industrial production declined in the closing months of 1982 to a level well below that of the previous year, while the inflation indicators showed a significant improvement. Despite some tax increases, consumer prices rose by 10.1% in 1982 compared with 11.7% in 1981, while wholesale prices posted a 10.3% increase compared with 16% in the previous year. Despite some weakness of the kroner during the year, raw material prices rose by 9.9% compared with a huge 27.3% in 1981. However, the country still faces severe problems. Its inflation rate remains higher than those of most of its trading partners and its trade deficit widened in 1982 to Kr 13 billion compared with Kr 10 billion in 1981. This suggests that, despite some reduction in the interest charges on its large overseas borrowings, the current-account balance showed no improvement in 1982 from 1981's Kr 13 billion deficit. As a result, the government is expected to announce further expenditure cuts during the year and also to defend strongly its proposals that wage rises should be limited to 4%.

Restrictive policies expected to help bolster Dutch current-account surplus.

The Netherlands' new government has introduced a tough budget for 1983. Spending has been cut 13 billion guilders from previously planned levels, largely via a freeze on public-sector wages and social benefits. In addition, higher personal income taxes are expected to increase revenues over previous plans. The hope is that the public-sector deficit can be held below 10% of national income, rather than nearly 12% if policies are not changed. Over the longer run, the government aims to reduce the deficit to 7.4% of national income by 1986. An incomes policy has also been agreed on for the private sector: wages were raised by only 2% in January in return for a shorter working week—but no reduction in total man-hours. In the short run, these policies will reduce domestic demand. This in turn—combined with Holland's improved international competitive position, lower world oil prices, and a recovery in the rest of Europe—should lead to another rise in the current-account surplus, estimated at some $5 billion in 1982.

Singapore awaits revival of export markets.

Despite a recent improvement in domestic interest rates, Singapore's business community is eyeing the prospects for a revival of economic activity with caution. The economy has suffered a severe slowdown in export growth. And because of a paucity of export orders, utilization of the country's productive capacity has continued to deteriorate. A survey by the Department of Statistics showed that some 64% of those businesses polled felt that conditions will remain depressed through the first half of 1983. Official government forecasts seem to concur. Prime Minister Lee Yuan Yen recently projected a modest 2%-3% real growth for 1983 and warned that businesses may soon be forced to begin laying off workers—despite the existence of a labor shortage just last year.

Chile seeks rescheduling of debt.

Chile is experiencing serious external payments difficulties. Net International reserves dropped by over $1 billion from the end of September through January—with nearly half of that occurring in the last month—and they continue to decline. The country's net reserves position stands at approximately $1 billion, the equivalent of some two months of imports of goods and services. The difficulties incurred in meeting service payments on the total external debt of $18 billion—$4.2 billion of which is short-term—has led the authorities to seek a rescheduling of the approximately $4 billion in maturities owed to commercial banks coming due in 1983-84. While discussions are underway, a 90-day standstill on principal payments due on all debt (except short-term, trade-related) has been arranged.

Argentina on the slow road to recovery.

Argentina is making continued progress in climbing out of two successive years of economic decline. Manufacturing output turned up sharply in the final quarter of 1982, after nearly three years of stagnation. In addition, an excellent harvest is promising record grain exports, while a unified and flexible exchange-rate policy should boost industrial goods. Furthermore, the IMF's approval of a SDR 2 billion program, coupled with the first and second disbursements of a $1.1 billion commercial-bank bridge loan, has bolstered confidence in Argentina's access to international financial sources. Despite these gains, the country is still struggling to cope with an inflation rate that reached 209.7% at year-end 1982. In part, this upsurge was due to corrective adjustments of public sector tariffs and prices. At the same time, however, an improvement in inflation expectations hinges on the success of the government's efforts to reduce the fiscal deficit as a percentage of GDP—from 14% in 1982 to 5% by March 1984.

Modest growth slowdown ahead for Pakistan.

Pakistan is expected to record real growth of around 6% in fiscal 1982-83 ending June 30, about the same as the 6.3% growth of 1981-82. Assuming favorable weather, a recovery in the wheat crop is expected to push agricultural production up 5% or better, in contrast to last year's increase of only 3%. But this is likely to be offset by a slowing of industrial growth to around 8%-9% from 1981-82's rapid 12% rate. The outlook for 1983-84 and beyond is more problematic. Growth is likely to be lower than the 6%-plus rate of recent years. The recent trend in agricultural growth of 4% per year will be difficult to sustain without significant success in raising crop yields. In addition, the boost to industrial productivity provided by new capacity additions will begin to taper off once the Karachi steel mill is completed, although deregulation could provide a powerful shot in the arm to domestic industry. Finally, once the IMF's Extended Fund Facility program comes to an end in November 1983, Pakistan's ability to finance its balance-of-payments funding gap may restrain growth. Real growth of 5.5% is possible in 1983-84, but growth thereafter could fall to the 4.5%-5.5% range.

Gabon current account expected to remain in surplus.

Gabon's oil-dominated economy experienced a number of favorable developments last year including improved oil production prospects, a balanced budget despite substantial growth of investment expenditure, a continued surplus on the overall balance of payments, and rising net foreign assets. The external debt was reduced for the third straight year and is expected to bring 1983 debt-service obligations below 10% of foreign exchange receipts. Nevertheless, economic growth stagnated in 1982 because of weakness in the non-petroleum sectors where diversification so far has remained an elusive goal. Any pickup in growth this year will depend on the strength of the rebound in Gabon's export markets. Allowing for a $3.50-per-barrel fall to $31 in the average price of Gabon's 7 million tons of oil exports, the 1983 current account should still show a comfortable surplus. While the overall balance of payments is likely to swing into deficit, an ample reserve cushion could easily finance the gap. But in view of the excessive dependence on oil earnings—80% of total exports in recent years—sharp variations in the price of oil will remain the critical element in the country's external accounts over the medium term.

Oil States Hit by Sagging Prices

The petroleum-rich regions of the United States that have prospered from the spectacular rise in energy prices over the last decade are now beginning to feel the effects of softer oil markets. For states such as Alaska, Louisiana, Oklahoma, and Texas—which hold a dominant share of U.S. petroleum and natural gas resources—the gains in economic activity, personal income, and tax revenues from the production, processing, and transport of state oil and gas deposits are tapering off, if not evaporating. Consequently, just as their Northeast and Midwest counterparts had to do a few years back, these oil and gas states are being forced to adjust to a changing order.

Because the governments of the petroleum-producing states have become so dependent on energy-related revenues, they are particularly sensitive to shifting conditions in the oil market. Tax and royalty income from natural resources in these four states—most of it from oil and gas—totaled $37.7 billion from 1973 to 1982. Direct oil and gas tax receipts, according to latest available data, rose to $5.8 billion in 1981 from only $644 million in 1972. As a percentage of the total 1981 state and local tax take, these direct taxes on production came to 80% for Alaska, 20% for Louisiana, 20% for Oklahoma, and 16% for Texas. Reported rent and royalty income in these states for 1981 was $2.9 billion. These revenues have gone far, not only to finance public expenditures, but also to provide tax relief both to households and to businesses not associated with oil and gas production.

Because of reduced energy demand in general, and continued uncertainty over oil prices in particular, these revenues will be sharply curtailed—and at a time when many state and local governments can least afford it. Budgets are already strained by the effects of the prolonged recession and the Reagan administration's attempts to reduce the involvement of the federal government in local affairs. To meet potential revenue shortfalls, the oil producing states will now have to tax other sources aggressively or cut spending.

Nevertheless, the fiscal strains are not likely to do severe long-term damage. Most of these governments, rather than devoting increased revenues from oil and gas to significantly higher expenditures, opted instead for general tax relief. Even Alaska, which did increase outlays sharply, reduced taxes and created an oil and gas trust fund at the same time. Moreover, because their overall tax burdens are already well below those of other states, the oil and gas states can easily raise low (or zero) property and income taxes without seriously hurting their local economies or taxpayers. Had these governments followed a policy of using the windfall oil revenues to provide more public goods and services, the situation would be far more difficult.

Vincent Salvo

The Perils of Credit-Watching

With M1—narrowly defined money—behaving unpredictably and the wider measures, M2 and M3, showing unsightly bulges, the Federal Reserve has decided to incorporate an even broader aggregate into its decision-making. Fed Chairman Paul A. Volcker reported in his congressional testimony in mid-February that the Federal Open Market Committee has begun to look at a measure of credit—total domestic non-financial debt—in addition to the more-familiar measures of money growth. He said the FOMC believed that a credit-growth range of 8½%-11½% would be an "appropriate" expectation for 1983.

Although Volcker stressed that the Fed has not yet elevated this growth range to the status of a "target," he left the door open for such a move, noting that the current period was "experimental." The FOMC, he declared, "does intend to monitor developments with respect to credit closely for what assistance it can provide in judging appropriate responses to developments in the other aggregates." Such an approach—considering credit as well as money growth in formulating monetary policy—has a certain amount of support among critics of monetary targeting. It is doubtful, however, that such a strategy will improve the functioning either of monetary policy or of the economy as a whole. It may even make matters worse.

Proponents point out that there has been a close long-run relationship in the United States between national income and total credit. Thus, they maintain, the credit measure—combined with a money target—would give the authorities additional signals to indicate the proper direction of policy.

The close relationship between credit and national income in the past, however, does not mean that it will continue in the future or that it will be a useful guide for monetary policy. As Volcker acknowledged in his congressional testimony, "data for such a broad credit aggregate are not yet available monthly, nor are the tools available to influence closely total flows of credit." Moreover, in practice, the Fed would have to target on changes, or net flows, in credit rather than on the existing stock of debt. But these are only loosely correlated with national income growth.

More fundamentally, the switch in strategy fails to consider the nature of the relationship between money and credit. Money is the basic determinant of the level of prices, and the rate of money growth ultimately determines the long-run underlying rate of inflation. Money acts as an eventual constraint on the growth of credit, since money is the primary means of settling debt. But limiting the growth of credit will not necessarily constrain money growth. Moreover, by diverting attention from the monetary aggregates and giving the Fed further justification for relaxing its grip on the money stock, the new focus on credit increases the likelihood that long-run money growth will be less predictable. Consequently, interest rates may be augmented by needless uncertainty premiums. *D. Sykes Wilford*

Latin America Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GDP IN 1982		BALANCE OF PAYMENTS						MONEY AND BANKING							COUNTRIES
		6 months ending	change from year earlier	in billions of dollars	$ per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	12-month changes: latest data	consumer prices	latest data	money supply(M1)	exchange rate in U.S. dollars, February 23, 1983	change from year earlier	current monetary conditions	
Argentina	Good grains harvest and revival of industrial activity promise economic recovery.	Dec.	−18%	130.0	4,594	Oct.	3,073	−12%	7.0	0	IMF approves SDR 2 billion program.	Dec.	+210%	Oct.	+187%	.00002	−82%	"Neutral" interest rate policy being followed.	Argentina
Bahamas	Recent increase in tourist arrivals promises recovery from two years of recession.	Sept.	+ 8%	1.4	5,600	Dec.	113	+13%	2.6	0	Foreign capital inflows help payments.	Nov.	+ 4%	Oct.	+ 9%	par	0	Credit conditions are restrictive.	Bahamas
Barbados	Economic decline provoked by impact of lower earnings from tourism, sugar, and exports.	June	+19%	0.9	3,333	Dec.	121	+21%	2.6	24	IMF program on target.	Oct.	+ 10%	Oct.	− 5%	.4972	0	Reserves slowdown causes money decline.	Barbados
Brazil	Cuts in public spending depressing consumer demand while unemployment is rising.	Dec.	−13%	293.0	2,382	Sept.	4,185	−23%	2.4	550	Cruzeiro devalued by 23%.	Dec.	+102%	Nov.	+ 70%	.0028	−62%	Government attempting to lower high real interest rates.	Brazil
Chile	GDP declined about 15% in 1982; prospects are for continued deterioration this year.	Dec.	−10%	23.7	2,060	Dec.	1,815	−44%	6.4	6	Negotiations underway to reschedule debt maturing in 1983-84.	Dec.	+ 21%	Dec.	− 8%	.0134	−49%	Liquidity declining.	Chile
Colombia	Government undertaking reforms of financial sector to bolster public confidence.	Sept.	− 6%	39.0	1,423	Dec.	3,862	−19%	8.4	0	Non-coffee exports decline.	Dec.	+ 25%	Nov.	+ 20%	.0140	−28%	Credit to public sector is reduced.	Colombia
Costa Rica	Economic activity will continue to deteriorate as a result of weak investment activity.	Oct.	−19%	2.8	1,164	Dec.	226	+72%	3.1	93	Slow progress on $1.4 billion commercial-debt rescheduling.	Sept.	+109%	Nov	+ 65%	.0250	−58%	Liquidity is tight.	Costa Rica
Dominican Rep.	Economic activity likely to be curtailed in light of restrictive fiscal and monetary policy.	Nov.	−30%	8.2	1,464	Dec.	129	−43%	1.1	71	Negotiations underway to reschedule debt owed foreign commercial banks.	July	+ 7%	Oct.	+ 22%	par	0	Restrictive credit conditions continue.	Dominican Rep.
Ecuador	Softer oil prices and flood damage to export crops depress foreign-exchange outlook.	Dec.	−17%	14.0	1,573	Dec.	304	−52%	1.8	0	Foreign banks offer public-debt refinancing.	Oct.	+ 21%	June	+ 18%	.0140	−53%	Credit is extremely restricted.	Ecuador
Guatemala	GDP declined 3.5% in 1982; further deterioration expected this year.	Sept.	−12%	8.4	1,090	Dec.	112	−25%	1.0	105	Exports dropped to $1.16 bn. in 1982 from $1.3 bn. in previous year.	Sept.	− 1%	Sept.	+ 8%	par	0	Net foreign assets declining.	Guatemala
Honduras	Government investment in hydroelectricity and paper and pulp complex continues.	Sept.	−17%	2.8	718	Nov.	143	+53%	2.7	104	Imports dropped $100 million in 1982 to $1.2 billion.	Sept.	+ 11%	Sept.	− 3%	.5000	0	Monetary policy is tight.	Honduras
Jamaica	Aluminum majors agree to keep Alpart refinery operating, but at half its production capacity.	Oct.	−26%	3.1	1,378	Nov.	85	−45%	0.7	583	United States will buy 1 million tons of bauxite for its strategic stockpile.	Oct.	+ 6%	Oct.	+ 47%	.5600	− 2%	Monetary policy is restrictive.	Jamaica
Mexico	Real GDP dropped by 0.7% in 1982 as inflation climbed to 98.9% by year-end.	Sept.	+15%	207.0	2,836	July	1,629	−44%	1.3	221	Foreign-exchange cover given for private loan reschedulings.	Dec.	+ 99%	Sept.	+ 58%	.0142	−48%	More credit to be channeled to private sector.	Mexico
Panama	Economy growing slowly owing to depressed international markets and domestic restraints.	Sept.	+21%	4.0	2,020	Sept.	100	−18%	0.7	84	Oil pipeline earnings add to revenues.	Oct.	+ 4%	May	+ 9%	par	0	International banking sector experiencing good growth.	Panama
Paraguay	Construction slowdown and depressed commodity prices cause record GDP decline in 1982.	Nov.	+ 8%	5.7	1,691	Nov.	719	− 8%	13.2	0	Capital inflows fall as dam projects are finished.	Sept.	+ 4%	Aug.	− 4%	.0079	− 4%	Credit is extremely restricted.	Paraguay
Peru	Real GDP rose 0.7% in 1982, reflecting primarily a 2.3% drop in manufacturing activity.	Sept.	+ 1%	19.8	1,053	June	1,444	+19%	5.4	571	Preliminary estimates put total external debt at $11.2 billion.	July	+ 62%	April	+ 46%	.00098	−52%	Monetary stance is restrictive.	Peru
Uruguay	Economic stabilization program implemented in context of an IMF standby arrangement.	Aug.	−29%	9.4	3,240	Oct.	229	−37%	2.3	96	New tariffs on imports range from 10%-55%; previous maximum was 75%.	Sept.	+ 15%	June	− 6%	.0323	−63%	Reserve requirements raised.	Uruguay
Venezuela	Slight 0.4% real GDP growth achieved in 1982 despite 10% oil output drop.	Dec.	−20%	73.0	4,966	Dec.	6,579	−19%	6.1	0	Refinancing of public short-term debt planned; exchange controls set.	Oct.	+ 9%	Aug.	+ 6%	.2328	0	Interest rates high to stem capital flight.	Venezuela

BEST AVAILABLE COPY

World Interest Rates

market rates of Feb. 23, 1983; bond yields as of Feb. 18, 1983

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	8.50	9.43	11.00 intervention rate	11.50	9.50	5.00	18.00 penalty rate 21.00	4.50	4.50	5.50
Day-to-Day Money	8.375 February 24	12.50	11.00	10.85	12.688	5.50	19.00	5.00	4.375 1-month Euro-Swiss fr. rate	6.375
Treasury Bills 91-day, Middle Rates	7.92	9.20	10.875	12.25	n. a.	n. a.	17.95 93 days	no dealing	no market	5.625
Commercial Paper prime, 3-month, asked	8.375 finance paper discount basis	9.45 finance paper 15% tax w/h	10.414	11.40 Certified	13.063 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	8.25	9.35 15% tax w/h	10.937	11.40 Certified	not traded	6.30	19.25	no market	3.125	no market
Government Bonds Long-term, new and old issues, average yield	10.87	12.00	10.91	10.63	14.30	8.00	19.07	7.74	4.24	8.09
Industrial Bonds prime, long-term, new and old issues, average yield	11.70 Aa Industrials	13.00	12.64	12.77	15.04	8.20	19.26	8.07	5.765	6.41
Bank Short-Term Rate (prime rate)	11.00	11.50	11.00	15.50	14.55	9.00	20.00 ⅛ qtrly fee on outstdng.	7.00	7.50	6.00
Bank Time Deposits 3-month	8.30 Cert. of Dep.	7.50	11.375	12.05	13.063	5.60	11.50	5.00 large deposits	2.00 residents only	3.75 20% tax w/h
Eurocurrencies 3-month, asked	9.0625	9.625	11.5625	no market	22.625	5.5625	no market	4.8125	3.125	6.6875
Exchange Rates—in U.S.$ rates floating against the $	—	.8133	1.5175	.0209	.1455	.4126	.0007	.3733	.4913	.0042
Forward Exchange Cover** 3-month, in percent p.a. *D* = discount, *P* = premium	—	.541 *D*	2.530 *D*	5.213 *D*	12.646 *D*	3.490 *P*	12.308 *D*	4.179 *P*	5.943 *P*	2.353 *P*

Eurodollar Deposits
(London, interbank, bid)
February 24

7-day	8.875
1-month	8.875
3-month	9.063
6-month	9.313

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−0.276
U.S.-Canada Treasury Bills	−0.409
U.S.-Canada Finance Co. Paper	−0.404
Eurodollars-U.K. Local Auth. Deposits	+0.280

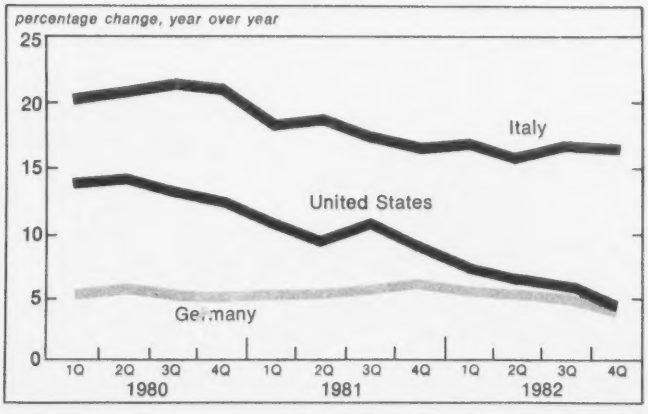
Eurobonds
(average yield on recent straight debt issues)

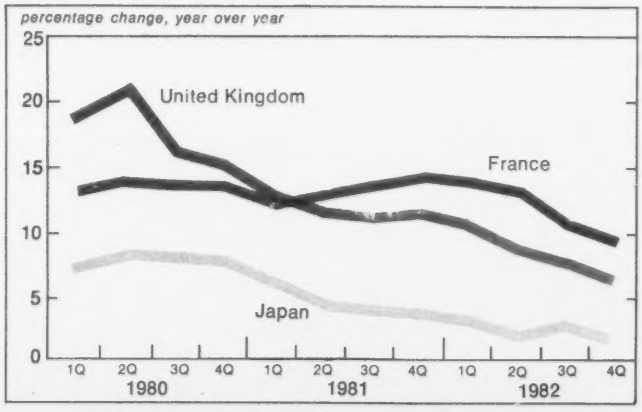
U.S. Dollar Bonds	
7 yrs. and under	10.375
Over 7 yrs.	11.00
DM Bonds	
7 yrs. and under	7.00
Over 7 yrs.	7.25

Gold Price
London afternoon fixing
470.25
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate (prime rate), while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Consumer price trends in major industrial countries





BEST AVAILABLE COPY

Weighing the Fed's Policy Options

The following is adapted from the statement of **J. Richard Zecher,** *Chief Economist of The Chase Manhattan Bank, before the Senate Committee on Banking, Housing, and Urban Affairs on February 18.*

Monetary policy has gone through three distinct regimes since World War II. The first began shortly after the war and had, as a centerpiece, the fixing of the dollar in terms of gold and the fixing of many other currencies in terms of the dollar. This period, from the late 1940s to the late 1960s, was characterized by relatively low inflation and interest rates and by a relatively rapid expansion in economic activity. The second monetary regime was marked by the severance of the dollar from gold in 1973, and by the two oil-price shocks of the middle and late 1970s. This period experienced considerably higher average levels of money growth, inflation, and interest rates than were common during the earlier regime. By 1979, the developing trends for money growth, inflation, and interest rates—and the associated decline in the international value of the dollar—forced a change to a third regime.

The third monetary regime extended roughly from October 1979 to about midyear 1982. A commitment to reduce growth rates in the monetary aggregates, and to reverse the accelerating inflation of the 1970s, was made in 1979 and carried out in large measure during the period extending to last summer. However, the implementation of this policy was far from smooth, intensifying the volatility in interest rates and the extended period of slack in the economy that was expected to accompany disinflation.

For a variety of reasons, money growth since last summer has been very rapid, leaving the Federal Reserve faced with two choices: (a) accommodate this rapid expansion by generating the required growth in the monetary base or (b) apply the monetary brakes again, slowing growth in the aggregates but in the process causing another interest-rate cycle. The Fed chose in this case to abandon aggregates targeting, ending the third monetary regime since the War.

The question now is what policy regime will replace the old one. Will monetary policy drift back toward the interest-rate targeting that led to the crises of the late 1970s? Will it return to a modified aggregates policy that eliminates some of the worst implementation problems of the 1979-82 period, but retains the critical long-term commitment to low inflation through low money-growth rates? Or will it simply drift?

In October 1979, the Federal Reserve initiated a monetary policy designed to reduce the rate of inflation in the United States. The policy was supposedly a "monetarist" strategy, that is, a policy designed to set and adhere to targets for long-term money growth. Thus, the Fed could pursue an aggregates targeting policy, allow for wider fluctuations in short-term interest rates, and curb the inflation rate—providing eventually lower interest rates with stable nominal income growth.

The policy was stated to be monetarist, but its implementation did not please the monetarists. The methods used to target the aggregates were those developed under interest-rate targeting. Consequently, during 1979-82, the strategy achieved neither its goal of minimizing the fluctuations of money growth nor its goal of minimizing the fluctuations in nominal income. But it *did* achieve its goal of stemming inflation.

The abandonment of the October 1979 experiment in late 1982 may mean an end to the process of disinflation. Under current Fed operating procedures, the rapid decline in interest rates experienced last summer guaranteed that there would be a rapid rise in money growth that would eventually pierce the upper target. A major question was whether the authorities would respond to above-target money growth by tightening monetary policy. Recent experience indicates that the answer, so far, is no. But how long they will be able to ignore the rapid rate of money growth, should it continue, remains an unanswered question.

The view that money growth may be very moderate in the coming months is, fortunately, more than just wishful thinking. Given the Fed's operating procedures, a period of very slow money growth is, in fact, highly likely. Three transient influences explain most of the rapid growth in money since last summer. The first—the rapid decline in interest rates and the Fed's response—ran its course by December. The other two, involving the introduction of bank money-market and super-N.O.W. accounts, have caused distortions in the monetary aggregates that we believe will be largely dissipated by the end of February. Of course, if this analysis proves wrong and the aggregates continue to grow rapidly, inflation will once again return to the center stage of our concerns.

Alternative courses

Having abandoned monetary targets in the last half of 1982, the Federal Reserve is now perceived by many to be adrift. The problem is that there now is no guide for evaluating long-run Fed policy. Under aggregates targeting, one knew something about the long run, even if there remained tremendous uncertainties about the short run. Today we have the opposite problem. We have short-run stability in financial markets relative to recent experience but greatly increased uncertainty about the long run.

Weighing the Fed's Policy Options *(continued from page 7)*

The recent behavior of the monetary aggregates is consistent with several possible courses the Fed may have chosen to pursue. The market is now attempting to judge which strategy will eventually be followed. At least three interpretations are feasible. First, money growth and the behavior of both short- and long-term interest rates have been consistent with a monetary-aggregates policy predicated upon the belief that inflation is under long-run control. In this view, inflation expectations have fallen sufficiently to allow the level of the money stock to increase once and for all, for the temporary reasons detailed above. After a period of adjustment, a new set of aggregates would be announced and a continuation of the earlier aggregates policy could be reinstituted. Second, the recent rise in the stock of money—including the monetary base—is consistent with an interest-rate targeting policy that may or may not prove to be inflationary. And third, the recent experience is perfectly consistent with no policy at all—that is, with a monetary authority adrift, searching for direction after abandoning an approach that was proving to be too costly.

Beginning with the last interpretation first, there is a danger that this view of a floundering Federal Reserve may become the accepted wisdom of the market. Such a course for the Fed—one dictated by fears of Congress, of the White House, or of other political constituencies—would open the economy to a multitude of problems. With the authorities adrift, it is possible that the investing and saving public would have to deal with uncertainties large enough to abort the incipient recovery and trigger another recession.

If the second interpretation—that the Fed has returned to interest-rate targeting—proves to be correct, it could prove to be inflationary, deflationary, or neither, depending on how it is handled. In either case, the policy does not lend itself to predictable results beyond the immediate period.

The first course—a return to some type of aggregates targeting—appears to be the only logical long-run strategy for the Fed to pursue. The system needs to be firmly anchored by a credible Federal Reserve anti-inflationary policy. The markets must have information about the long-run direction of policy in order to make long-term investment decisions. This does not mean a return to the experiences of the October 1979-October 1982 period, but it does mean an assurance to the public that an aggregates-targeting policy is being adhered to in the long run.

Because of the fragile state of the incipient economic recovery, the choice of a proper course for monetary policy is now of the utmost importance. In 1979 there were two major shocks to the world economy: a shift to disinflationary policies and a dramatic increase in oil prices. Both contributed much to the past three years of stagnation in the U.S. and global economies. The oil-price increase has had a more-permanent effect on U.S. economic activity, lowering our long-run potential real growth path by reducing the economic efficiency of our capital stock and our workers.

Nevertheless, there are growing signs that the economy at last is beginning to pull out of the recessionary period of the past three years. Our reading of the current indicators of economic activity suggests that this quarter should show positive economic growth, and that the prospects are good for real GNP growth of 4% or more between the fourth quarter of 1982 and the fourth quarter of 1983.

Forecasting risks

There is one big *positive* risk to this forecast. We may now be seeing that the oil-price shock was a temporary phenomenon. The large and rapid responses of industry and consumers to the relative-price shifts may have been sufficient to ensure that relative oil prices in the United States during the 1980s will be similar to those of the pre-1979 shock. If this is the case, then we may be underestimating the U.S. potential-output path. The dynamic readjustment to a higher potential output would mean that 1983 and 1984 taken together could be a period of very strong real growth, compared with past recoveries from recessions.

On the other hand, the *negative* risks to our forecast are larger than the risks of underestimating real growth. First, as noted earlier, there is a great deal of uncertainty about the course of monetary policy. A major risk is that a reignition of the world's economic engine could result in a coordinated acceleration of inflation, much as the policies of 1980-82 resulted in a coordinated disinflation. This would lead eventually to a rise in interest rates—both nominal and real—from their already high levels, and depress investment and other interest-sensitive expenditures.

In addition, events of the past four years, particularly disinflation and the oil-price shock, have been as debilitating to governments—in their abilities to manage spending, taxing, and deficits effectively—as they have been to the private side of the global economy. Government deficits are everywhere large, and present serious problems to virtually every national government. The degree of success in regaining control over government spending and borrowing requirements will become increasingly important as the private economy recovers.

Monetary policy is clearly at a crossroads. The economic costs of breaking the inflationary cycle have now been paid in terms of high unemployment and lost output. By reaffirming the principle of aggregates targeting as a long-run strategy, the Federal Reserve can maintain its hard-won credibility and preserve the gains that have been made at so high a sacrifice.